

Banking Sector Reforms and Critical Factors in Nigeria's Economic Growth Process

Nathanael O. Eriemo, PhD

Department of Economics, Delta State University, Abraka, Nigeria

E-mail: etekwene@yahoo.com

Abstract

The paper investigates the impact of the banking sector reforms on the Nigerian economy using the Ordinary Least Squares (OLS) technique in assessing the data on variables from 1980 to 2012. The result showed that the minimum capital base which is at the heart of the banking sector reform has a positive and significant relationship with the level of economic growth. This is an indication that the banking sector recapitalization has been beneficial and capable of generating the desired level of economic progress in Nigeria. The result shows that the high interest rate policy has been detrimental to the level of economic progress in Nigeria. The result further revealed that the expansionary monetary policy has been crucial and critical in the development process in Nigeria. It is thus recommended amongst others that the monetary authorities should further increase the minimum capital base and there should be perpetuation of the expansionary monetary policy.

Keywords: Banking Reforms, Capitalization, Expansionary Monetary Policy, Economic Progress

Introduction

The banking industry as a key unit of the financial system, all over the world, plays fundamental role in the development and growth conditions of the economy by acting as bulldozers in the mobilization of funds and the creation of wealth. The effectiveness and the efficiency of performing its roles, particularly the intermediation between the surplus and the deficit units of the economy, depend largely on the level of development of the financial system and so banking reform is imperative when existing structures are defective as was the case in Nigeria's pre-reform era. It is with the intent to ensuring its soundness that the financial sector appears to be the most regulated and controlled by the government and its agencies. There is therefore no doubt why the consensus opinion has been that such a formidable sector must be kept healthy and steadily forceful through regular reforms. Accordingly, it is observed that the success of other reforms depends on the health of the financial system (World Bank, 1996).

It is increasingly recognized that the financial system plays a crucial role in the process of economic development (Todaro and Smith, 2011). The surveillance role of the regulatory/supervising authorities is critical to ensuring the soundness and efficiency of financial institution in order to build up confidence and stability of the system. Some of the components of the financial system include the money market comprising commercial banks, Central Bank of Nigeria (CBN); Nigeria Deposit Insurance Corporation (NDIC), the capital market and its connection with the Security and Exchange Commission (SEC) among others.

Policy responses such as fiscal adjustment, trade globalization, financial deregulation as well as privatization programmes were embarked upon by countries especially the less developed countries (LDCs) with a view to redressing the problems of slow growth, debt overhang as well as ameliorate the external and internal shocks.

In Nigeria, the banking fundamental restructuring as orchestrated by successive banking reforms and policy have sought to improve the process of financial intermediaries that would fund and foster stronger economic growth. Consequently,

banking sector reforms in Nigeria could conveniently be discussed under the following eras: the post-SAP era – (1986 -1993). The Reforms Lethargy (1993- 1998), the pre-Soludo era. The first is the financial systems reforms of 1986 to 1993 which led to deregulation of the banking industry which hitherto was dominated by indigenized banks with over 60% Federal and State governments' stakes, in addition to credit, interest rate and foreign exchange policy reforms. The second phase began in the late 1993 -1998, with the re-introduction of regulations. During this period, the banking sector suffered deep financial distress which necessitated another round of reforms designated to manage the distress. The third phase began with the advent of the present civilian regime in 1999 which saw the return to liberalization of the financial sector accompanied with the adoption of distress resolution programmes. This era also witnessed the resolution programmes. This era also witnessed the introduction of universal banking which empowered the banking and non-banking financial markets. The fourth phase began in 2004 till date and it is informed by the Nigerian Monetary Authorities who asserted that their catalytic role in promoting private sector led growth could be further enhanced through a more pragmatic reform (Balogun, 2002).

The fourth phase of the banking reforms in Nigeria essentially started with the appointment of Charles Soludo as governor of the CBN by the Obasanjo civilian administration in 2004. The phase also embraces the extant regime of Sanusi Lamido Sanusi which, with intense globalization attendant with increased pressure on financial performances brought about significant changes in the financial sector as the country adopted comprehensive adjustment programme designed to promote a stable macroeconomic environment and provide a versatile institutional arrangement necessary for a free market economy. (Aderibigbe, 1997).

The rest of this paper proceeds as follows: Section 2 briefly reviews the relevant literature. Section 3 describes conceptual and theoretical framework; section 4 presents model specification and analysis of results and finally section 5 presents policy implications and concluding remarks

. Review of the relevant literature

Banking sector reform, according to Olekah (1993) is a policy measure designed to deregulate the financial sector system and transform its structure with the view to achieving a liberalized market oriented system within an appropriate regulatory framework.

Prior to the economic deregulation measures of 1986, the Nigerian banking industry was highly characterized by control in interest rate, selective credit guideline, ceiling on credit expansion and the use of reserve requirement and other direct monetary control instrument. The banking system was dominated by the state owned banks while entry into the industry restricted consequent upon the adoption of the structural Adjustment Programme (SAP) in 1986. The framework for banking reform in the country was put in place with the primary objective of the stemming the expansionary impact of government modernization of oil export proceeds and the monetary financing of budgeting deficits. The banking sector thus focuses on measure to promote a more competitive and safe system through enhanced surveillance activity by the monetary authorities with the view of moving the Nigeria economy productivity and positioning the banking system to perform the role of intermediation and playing a catalytic role in the economic development (CBN 2005).

In Nigeria, the ability of the banking industry to play its role has been periodically punctuated by its vulnerability to systematic distress and macro-economic volatility, making policy tuning inevitable.

Nnanna (2005) showed that historically, the Nigeria banking industry had evolved in four stages; the first stage can be described as the unguided less-fair phase, during which several poorly capitalized and unsupervised indigenous banks failed before tenth anniversary. The second stage was the controlled regime during which the central bank of Nigeria ensures that only “fit and proper” persons were granted banking license, subjected to a mini paid-up capital. The third stage was the post SAP or the control regime (1986-2003), during which the neo-liberal philosophy of “free entry” was over stretched and the banking license were dispensed by the political authorities on the basis of patronage. The emerging fourth stage is the era of consolidation (2004 to a foreseeable future) with major emphasis on the recapitalization proactive regulation based on prudential principles.

The financial industry is reconstructing and consolidating at an unprecedented pace around the globe, particularly in the United States and Western Europe, transactions are numerous and breath taking is not only a Nigeria thing, but all around the world.

Alan (2010) categorized financial reform into two, namely financial reform, which is essentially the process of eliminating state of distress in financial institutions as well as main causative factors. The second is financial reform proper which is the processes of changing institutions and adding new ones and also eliminating the distorting financial policies and practice with greater mobilization and allocation of scarce resources. These two forms of reforms have been simultaneously used in Nigeria depending on the objectives of the government.

Conceptual and Theoretical Framework

Banking reforms is the changing of banking system architecture, technological innovation, and fine-tuning the rules guiding the practice of banking in many jurisdictions, Okagbue and Aliko (2004).

Ajayi (2005) pointed out that reforms are predicated upon the need for reorientation and reposition of existing status quo in order to attain an effective and efficient state. Okeke (2007) posits that reforms are deliberate action by the government to fast track and consolidate specified sector of the economy to achieve desired objectives. Alan (2004) opined that banking reform is the process of changing structures, adding new policies, eliminating distorted banking policies and practices and generally establishing the basis of greater efficiency in both the mobilization and the collection of resources.

Banking reform thus focused on the establishment of necessary macro-economic framework and financial environment that would engender and promote a more competitive and safe system through enhanced surveillance activity by the authorities with a view to moving the economy forward, proactively positioning the banking system to perform the role of intermediation and playing a catalytic role in economic development CBN

(2005). The reform measures are agreed towards improving credit quality of banks. The goal is to see whether the banking reform will have effect on macro-economic indicators of the economy (Soludo, 2004).

Sundararajan and Balino (1991) identified several ways by which financial reform could increase the fragility of both financial and non-financial sector which includes relaxed freedom to entry into the financial sector and freedom to bid for funds through interest rates and new investment, which could lead to excessive risk-taking. Changes in the institutional structure of the banking system that emerges during reforms, led to concentration of power in banking and interlocking ownership and lending pattern.

- Excessive reliance on economic rather than prudential regulations, which should focus on bank solvency and credit risk.
- Mismatch of investments; the de-regulation of interest rate could affect financial institutions that have large exposure to long-term assets funded by short-term liabilities, which carry fixed interest rates.
- Inadequacy of instrument of monetary control or insensitivity to the need for the control of interest rates during de-regulation.

The manner of the implementation of the reform may facilitate the occurrence of any of the mentioned events, leading to banking crisis.

August (2004) opined that one reason de-regulation has been linked closely with bank failure is the simultaneous occurrence of the two events; bank failure and de-regulation of bank; the rapid rise in bank failure often takes place at a time of substantial de-regulation of the financial sector.

When these two events occurred at the same time it may not necessarily mean that one has cause the other neither does it mean that one has not caused the other. De-regulation is often accompanied by increased market competition. It compels banks to compete with one another for core deposits, their level of exposure to risk may increase as the spread between the cost of funds and the return on funds as a narrow (Sundararajan 1991).

In view of the important roles, which a well-developed financial market can play, the CBN is placed in a unique position to ensure the soundness and efficiency of the financial sector and market operations at both the micro and macro levels to support the economic objectives of government. CBN has also adopted various policy options to address problem of distressed banks. These policies adopted are: financial restructuring which attempts to restore solvency by improving bank balance sheet, by raising additional capital of N25 billion capital base enhancing supervision and prudential regulator studies which have that have explored the correlation between the banking sector and economic growth include Stiglitz and Weiss (1981), who developed some of the first banking –related models, based on utility and profit maximization. The studies focused on the role played by asymmetric information in resource allocation. Also, in the same vein, King and Levine (1993) have established that the banking sector's development correlated with economic growth and also a source of long term growth. Also, subsequent works resting on King and Levine have been able to demonstrate that financial markets are a source of economic growth (see for example, Nnana (2004), Lavine and Zervos (1996), De Gregorio and Guidolti (1995). Several empirical studies have been conducted on consolidation, recapitalization and banking sector reforms in Nigeria (see for example, Balogun (2007). studies lend credence to the impact of reforms in banking sector on economic growth

Model Specification and Analysis of Results

The model to be estimated is thus stated functionally below:

$$RGDP = FCR, MS, MCBASE, FINDEEP, REFDUM$$

Where,

RGDP = Real Gross Domestic Product

MS = Money Supply

R = Interest Rate

MCBASE = Minimum Capital Base

FINDEEP = Financial Deepening

REFDUM = Banking sector reform dummy. It assumes the period of 0 during non reforms and 1 during banking sector reform period.

Ut = Error term

This could be stated linearly below:

$$RGDP = b_0 + b_1R + b_2MS + b_3MCBASE + b_4FINDEEP + b_5REFDUM + U_t$$

$$b_2, b_3, b_4, b_5 > 0, b_1 < 0$$

Economic theory suggests that a well managed banking sector reforms is expected to increase the level of economic growth, all things being equal.

The data to be used for the study are secondary in nature and covered the period between 1980 and 2012 period which include the pre-Structural Adjustment Programme (SAP) and the SAP period. The data include those on Real Gross Domestic Product, minimum capital base, interest rate, financial deepening and a banking sector reform dummy variable which assumes the period of 1 during banking sector reform period and 0 in other period.

The result for the study is therefore presented below:

Dependent Variable: LRGDP

Excluded observations: 1 after adjusting endpoints				
Variable	Coefficient	Std. Error	t-Statistic	Prob.
LR	-0.483866	0.105696	-4.577960	0.0001
LMS	0.401158	0.193494	2.073233	0.0452
LMCBASE	0.472027	0.056578	8.342862	0.0000
FINDEEP	0.174436	0.086412	2.018652	0.0559
REFDUM	0.407183	0.059263	6.870795	0.0000
C	9.772005	1.111992	8.787837	0.0000

$$R^2 = 0.75, R^{-2} = 0.69, F \text{ statistic} = 34.19, \text{Prob} (F \text{ statistic}) = 0.0000, DW = 2.07$$

From the study it is observed that the MS, MCBASE and FINDEEP have a positive linear relationship with the RGDP, while the R has a negative linear relationship with the RGDP. An increase in the MS and MCBASE by 1 percent each increased the RGDP by 40 percent and 47 percent, an increase in FINDEEP by 1 unit increased the RGDP by 0.17 units. An increase in the R by 1 percent reduced the level of RGDP by 48 percent. The R^2 suggests that 75 percent of the total variation in the RGDP has been explained by the R, MS, MCBASE and FINDEEP taken together. This is a good fit since the unexplained variation is just 25 percent (1-0.75). The R^{-2} at 69 percent justified the inclusion of the R, MS, MCBASE and FINDEEP in the RGDP equation.

The F test with a value of 34.19 and probability of 0.000 indicates a validation of the joint alternative hypothesis of the joint regression plane. This is an indication that the R, MS, MCBASE, FINDEEP are important factors to be considered when explaining the changes in the RGDP. The t test suggests that the R, MS, MCBASE and FINDEEP with values of -4.58, 2.07, 8.34 and 2.02 with probabilities of 0.0001, 0.0452, 0.0000 and 0.0559 are statistically significant in explaining the changes in the RGDP. The DW test with value of 2.07 did not show evidence of first order serial correlation in the model. In addition to the analysis the trend in the variables are shown below reveal some phenomenon:

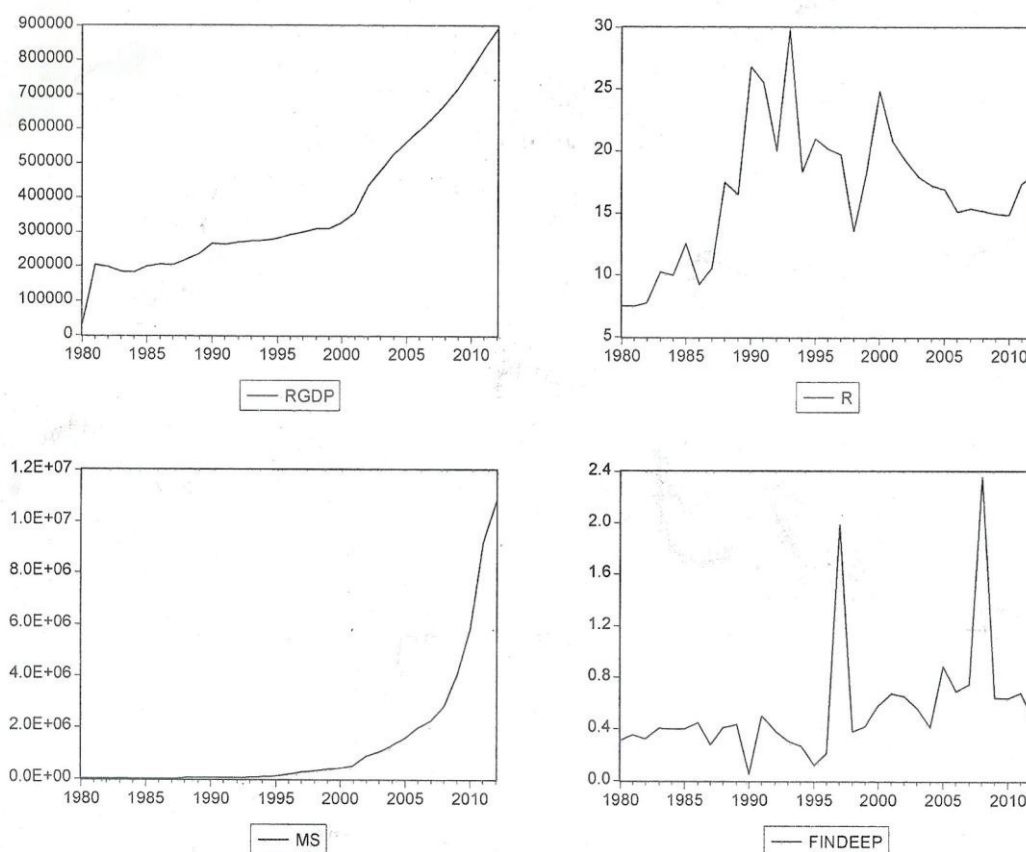


Fig. 1: Trend in the variables

The result shows that the level of economic growth was high in most of the study period. The fluctuation in the prime lending rate is an indication of flawed interest rate policies in Nigeria. The level of money supply is high in most of the study period. This is a reflection of the expansionary monetary policy pursued by the government. The level of financial deepening fluctuated in most of the study period. Further, the result also revealed that the banking sector reforms dummy variable is statistically significant. This is an indication that banking sector reform has produced desirable benefits on the level of economic growth in Nigeria. The minimum capital base has a positive and significant relationship with the level of economic growth as an increase in the minimum capital base by 1 percent leads to an increase of 47 percent in the level of economic growth. Since minimum capital base is the core of the banking sector reform programme, the result shows that the banking sector reforms have been beneficial on the level of economic growth in Nigeria. It is worthy to mention that interest rate has a negative and positive linear relationship with the level of economic growth in Nigeria. This is because 1 percent increase in interest rate reduced the level of economic growth by 48 percent. This is an indication that the high interest rate policy of the government has been harmful to the growth process in Nigeria.

Policy Implications and Concluding Remarks

The result has important implications for banking sector reforms and economic growth in Nigeria. The result shows that the banking sector reforms has improved the level of economic growth in Nigeria. The result indicates that the minimum capital base which is a major component of the banking sector reforms has beneficial impact on the level of economic growth in Nigeria. The result shows that the expansionary monetary policy of the government has influenced the level of economic growth in Nigeria. Banking sector reforms has formed a key component of financial sector reforms programme in both developed and emerging economies of the world. Effective banking sector reform was behind the economic success stories of the Asian Tigers which include South Korea, Singapore, Taiwan etc. In Africa, Nigeria specifically, banking sector reforms has not produced the

desired result. In Nigeria, the reforms of the financial sector began with the introduction of the structural Adjustment in 1986. This saw the increase in bank recapitalization which is currently at about 25 billion naira. The reforms of the banking sector also saw the drastic reduction in the number of banks in the country. The result however shows that the banking sector reform have beneficial to the level of economic growth in Nigeria. The result shows further that the high minimum capital base of N25 billion has strengthened the banking sector in Nigeria. This has increased the level of economic progress in Nigeria.

The following recommendations are therefore made for policy purpose:

- a)The monetary authorities should further increase the minimum capital base. This will further strengthen the banks and have an improvement in the level of economic growth.
- b)The government should continue with her policy of expansionary monetary policy by further increasing the level of money supply in the country. The proper utilization of the increased money supply will ensure the desired level on economic growth.
- c)The interest rate should be reduced. This will increase the funds available for investment which will increase the level of economic growth in Nigeria.

References

- Adelegan, A.E and Oriavwote V. (2014). An Empirical Analysis of Nigeria's Experience with Banking sector Reform, *International Journal of Economics, Business and Finance* Vol. 2, No. 1, January 2014, pp: 1 -12 ISSN, 2327-8188.
- Adam A.J. (2004) "Bank Regulations, Risk Assets and Income of Banks in Nigeria" *NDIC quarterly* Vol. 14, Abuja.
- Adeloye, L. (2008). "Industrial sector woes Deepen" *Sunday Punch*, 25 May.
- Aderibigbe J.O (1997) Monetary Policy and Financial Sector Reform "Abuja; the *central bank of Nigeria bulletin* October/December.
- Agusto O. (2004) beyond bank consolidation; "Effect on banking and real sector (Abuja)" being a test of paper presented at the 14th *annual monetary conference of the CBN*.
- Alo, E.N. (2010). "The Pains And Gains of Governor Sanusi's Banking Reforms And Unprecedented Effect of Over-Rated Professionalism". *Nigeria Focus.*, October 25.
- Balogun,E.D (2002). " A review of Soludo's perspective of banking sector reforms in Nigeria". A MPRA Paper 3803, university library Germany.
- Balogun, E.D. (2007). "A Review of Soludo's Perspective of Banking Sector Reforms in Nigeria". *Obtained from online at <http://mpa.ub.uni-muenchen.de>*.
- CBN (2004) *annual report and the statement of accounts*.
- CBN (2004) "Fact File on Bank Recapitalization" Abuja; a *publication of Central Bank of Nigeria*.
- CBN (2005) Impact of bank consolidation and the Nigeria economy *business guardian* December 31.
- CBN (2007) Recent Reforms in the Nigeria Banking Industry Issues and Prospects being that of paper delivered at the end of the year party; international; *the Clearing Bank Committee of CBN* (July 6-7)
- CBN (2008), *Annual Report and Statement of Account* , 31th December.
- CBN (2011) *Recent Reform in the Nigeria Banking Industry; "Issues and Prospects"* being a taste of paper delivered at the 2011 end of year party organized by the clearing house committee of Port- Harcourt branch, CBN.
- De Gregorio, y. and P, guidotti (1992). " Causes and environmental effects of banks failure in Nigeria" *NDIC Quarterly* 5(3) November.
- Ebulu, S; and Ajibade, A. (2008). "E-Banking: Complaints About Poor Service Quality Persist". *The Nation*, 29th September, pp.6-7.
- Ebulu, S. (2008). "Consumer Finance: A Relief or Debt Trap? The Nation, 25 June.
- Ezurike, N. (2005) Evaluating banking reforms "Industry Newspapers, Vol. 30 no. 8920 Monday (February 13) *CBN; statistical bulletin* Vol.16.
- Ezurike, N. (2005) "Evaluating the Banking Reforms" Lagos; *This day newspaper* 13 February.
- FOS (2004) Federal Office of Statistics at Abuja pp210.
- Imala, O. (2005) *Consolidation in the Nigeria Banking Industry; a strategy for survival and development*.
- Lekah, T.K. (1993). Macroeconomic Pre-requisites and the Consequences of Financial Sector Reform. Abuja; *the Bulletin CBN*.

- Levine, Ross and Sarra Zervos (1996). “ Stock market development and long-run growth” *World Bank Economic Review*.
- Levine, R (2004), “ Finance and growth, theory, evidence and mechanisms”, in phillipe Aghion and Steve Durlauf (ed), *Handbook of Economic growth*, Amsterdam, North-Holland.
- Magbagbeika, N.E (2004). “ Theoretical and conceptual issues in economic reforms Application to Nigeria’s downstream petroleum sector”. Central bank of Nigeria, *Economic and Financial Review* 42 (4)
- Nnanna O. (2004) “Beyond Bank Consolidation; the Impact on the Society” in *CBN 14th monetary policy conference*, Abuja.
- Nnanna, O. (2005) Beyond Bank Consolidation. “The Impact on the Society” a paper presented at the fourth *annual monetary policy conference of the CBN Abuja* 18th-19th November.
- Soludo, C. (2004) *Consolidation of the Nigeria Banking to meet the Developmental Challenges of 21st century*.
- Okagbue and Aliko (2004) *Banking Sector Reforms in Nigeria*.
- Oke I.E. (2008) Effect of the Recapitalization on the Nigeria Economy, *Sun Newspaper* January 21.
- Sundararajan, V and Balimo T. (2007) Issues on Recent Banking Crisis on *International Monetary Fund*, Washington DC.
- Yinka, K. (2004) N25 billion Capitalization, Malpractice nor Size at Bank of Nigeria banks; *Vanguard Newspaper* 19th Abuja.

The IISTE is a pioneer in the Open-Access hosting service and academic event management. The aim of the firm is Accelerating Global Knowledge Sharing.

More information about the firm can be found on the homepage:

<http://www.iiste.org>

CALL FOR JOURNAL PAPERS

There are more than 30 peer-reviewed academic journals hosted under the hosting platform.

Prospective authors of journals can find the submission instruction on the following page: <http://www.iiste.org/journals/> All the journals articles are available online to the readers all over the world without financial, legal, or technical barriers other than those inseparable from gaining access to the internet itself. Paper version of the journals is also available upon request of readers and authors.

MORE RESOURCES

Book publication information: <http://www.iiste.org/book/>

IISTE Knowledge Sharing Partners

EBSCO, Index Copernicus, Ulrich's Periodicals Directory, JournalTOCS, PKP Open Archives Harvester, Bielefeld Academic Search Engine, Elektronische Zeitschriftenbibliothek EZB, Open J-Gate, OCLC WorldCat, Universe Digital Library, NewJour, Google Scholar

